DEPARTMENT OF FINANCE

ARNOLD SCHWARZENEGGER, GOVERNOR

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March 9, 2006

Mr. John Rea, Acting Director
California Department of Industrial Relations
Attention: Director's Office, 10th Floor
455 Golden Gate Avenue
P.O. Box 420603
San Francisco, CA 94142

Dear Mr. Rea:

Final Report: California Department of Industrial Relations—Internal Control Review

Enclosed is our final report on the California Department of Industrial Relations' (DIR) internal control as of October 26, 2005. The Department of Finance, Office of State Audits and Evaluations, performed this review in accordance with the Financial Integrity and State Manager's Accountability Act of 1983, and pursuant to our interagency agreement with DIR.

The DIR's written response is included herein. Implementation of the proposed corrective actions will help strengthen the DIR's internal control and reduce the risk of errors or irregularities.

In accordance with Finance's policy of increased transparency, the final report will be placed on the Finance website. We appreciate the cooperation and assistance of DIR staff during our review. If you have any questions regarding this letter, please contact Frances Parmelee, Manager, or Rick Cervantes, Supervisor, at (916) 322-2985.

Sincerely,

Original signed by Diana L. Ducay

Diana L. Ducay, Chief
Office of State Audits and Evaluations

Enclosure

cc: Ms. Marisa Duek, Associate Secretary, Fiscal Policy and Administration, Labor and Workforce Development Agency
Mr. Jim Culbeaux, Manager, Information Systems, Department of Industrial Relations
Ms. Ann Rose, Chief, Division of Administration, Department of Industrial Relations
Ms. Tess Gormley, Senior Information Systems Analyst, Department of Industrial Relations

An Internal Control Review

California Department of Industrial Relations

Prepared By:
Office of State Audits and Evaluations
Department of Finance

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October 2005

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PREFACE

The California Department of Industrial Relations' (DIR) principal objective is to protect the workforce in California, improve working conditions, and advance opportunities for profitable employment. The DIR is responsible for enforcing workers' compensation insurance laws and adjudicating workers' compensation insurance claims and working to prevent industrial injuries and deaths. DIR also promulgates regulations and enforces laws relating to wages, hours, and conditions of employment, promotes apprenticeship and other on-the-job training, assists in negotiations with parties in dispute when a work stoppage is threatened, and analyzes and disseminates statistics which measure the condition of labor in the state.

State managers are required to maintain internal control in the programs they administer. Internal control is defined as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. This definition of internal control includes five interrelated components:

- *Control environment* sets the tone of an organization, influencing the control consciousness of its staff. It is the foundation for all other components of internal control, providing discipline and structure.

- *Risk assessment* is the entity's identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risks should be managed.

- *Control activities* are the policies and procedures that help ensure management directives are carried out.

- *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

- *Monitoring* is the process that assesses the quality of internal control performance over time.

The objective of our internal control review was to assist the DIR in complying with the Financial Integrity and State Manager's Accountability Act of 1983. Specifically, we assisted the DIR in determining whether: (1) assets are safeguarded from unauthorized use or disposition, (2) financial transactions are executed in accordance with management's authorizations and recorded properly to permit the preparation of reliable financial statements, and (3) financial operations are conducted in accordance with State Administrative Manual guidelines, and certain other state laws and regulations, as well as the DIR's policies and procedures.

Our review did not include an evaluation of the efficiency or effectiveness of DIR's operations, or the accomplishment of program goals or objectives.

This report is intended for the information and use of the DIR and is not intended to be and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

STAFF:

Frances Parmelee, CPA
Manager

Rick Cervantes, CPA
Supervisor

Michael Fontaine
Emmie Hoang
Lawana Welch
Kwabena Boakye

During our review of the California Department of Industrial Relations' (DIR) internal controls, we identified several areas where controls were in place and working as intended. The DIR's internal controls over its budget functions appear adequate to ensure the reliability and integrity of data. The Budget Office maintains current policies and procedures and properly records appropriations. In addition, the DIR's controls over financial reporting also appear adequate. We observed that the required financial statements are properly prepared, certified, and timely submitted. Our tests of controls indicated no reportable conditions for the Budget and Financial Reporting cycles.

We also identified areas where controls could be improved to reduce the risk of errors, irregularities, and material misstatements. We met with DIR management and staff to discuss the following reportable conditions and material weaknesses, as well as other non-reportable findings and observations. As shown in Exhibit I, a number of these findings were uncorrected findings noted in our Risk Assessment dated December 1997.

We also reviewed the Electronic Adjudication Management System (EAMS) procurement and issued a separate Management Letter regarding the internal controls over the EAMS procurement.

Material Weaknesses

Property
Controls over the accounting and recording of property are not sufficient to ensure the safeguarding of the state's assets or the reliability and integrity of data. Specifically, we found that:

- A physical inventory is not performed (Prior Finding 6).
- Fixed assets are not capitalized accurately.
- The property ledger is not reconciled to the general ledger (Prior Finding 5).
- The property ledger is inaccurate.
- Property is not disposed of properly.
- A Property Survey Board does not exist.
- Inadequate tagging of highly desirable property exists.
- The Statement of General Fixed Assets report is inaccurate.

Receivables
Controls over receivables are not sufficient to ensure that all amounts due to the DIR are collected and promptly recorded. Specifically, we found that:

- DIR is not establishing accounts receivable for amounts due in all areas for which receivables should be established (Prior Finding 9).

- DIR is not properly posting accounts receivable subsidiary ledger amounts to the applicable general ledger.
- Subsidiary records do not reconcile to the general ledger.
- DIR's collections program does not ensure that adequate collection efforts are made on past-due accounts receivable (Prior Finding 2).

Other Reportable Conditions

Revolving Fund: DIR's internal controls over its revolving fund are sufficient to ensure that reimbursement is made on a timely basis to prevent the fund from being overdrawn, and use is for authorized purposes. However, our tests of controls indicated that salary advances are not cleared timely (Prior Finding 4), excessive salary advances are given to employees, the Uninsured Employee Fund (UEF) and Subsequent Injured Fund (SIF) do not have adequate written claims procedures, and UEF reimbursement claims are not adequately reviewed.

Cash Disbursements: DIR's internal controls over cash disbursements are sufficient to ensure that cash disbursements are made for allowable purposes and are accurately and promptly posted. In addition, adequate separation of duties exists and bank reconciliations are timely. However, our tests of controls indicated that bank reconciliations are not accurately prepared, uncleared or unclaimed checks over one year are not cleared, and accountability of checks needs improvement.

Cash Receipts: Internal controls over cash receipts appear adequate to ensure the collection of receipts, adequate separation of duties, safeguarding of receipts prior to deposit, and prompt and proper recordation in the accounting records of respective funds. However, our test of controls indicated that remittances to the State Treasury are untimely, the Indirect Cost Rate Proposal approval procedures need improvement, and reimbursement deficiency claims are inadequate (Prior Finding 1).

Purchasing: DIR's internal controls over purchasing are sufficient to ensure that purchases of goods and services are properly authorized and made in accordance with state policies, open files of purchase documents and contracts allow prompt identification and follow-up of goods and services ordered, invoices are verified and processed promptly and accurately, established policies on the use of CAL-Card exist, and periodic reconciliations are performed to ensure that cumulative purchase expenditures do not exceed allotments. However, our tests of controls indicated that the computer purchase orders are split and stock received reports are not adequately documented in the accounting files.

Contracts: Internal controls over contracting are sufficient to ensure that contracts are adequately monitored to ensure compliance with contract provisions, contract amendments are proper, and all required reports are completed and filed with the Department of General Services. However, our tests of controls indicated that contract expenditures are not adequately monitored, splitting of contracts occurred, and encumbrances are not properly liquidated.

Personnel/Payroll: DIR's internal controls over its personnel and payroll functions appear adequate to ensure the reliability and integrity of data. We observed the implementation and maintenance of current policies and procedures, adequate separation of duties among staff, attendance records that support and properly certify salary payments, and proper employee appointment and separation procedures. However, our tests of controls indicated that overtime requests submitted by employees are not pre-approved and undeliverable salary warrants are not remitted timely.

Information Technology: DIR's internal controls over information technology, specifically related to fiscal and accounting functions, appear adequate to ensure the reliability and integrity of data. We observed adequate separation of duties, existence and implementation of current policies and procedures, a current listing of individuals authorized to approve, process, and receive information, and the implementation of effective security measures. However, our test of controls indicated that procedures for passwords and daily batch reconciliations need improvement.

Field Offices: The Division of Labor Standards Enforcement's field offices in Sacramento and Los Angeles appear to have adequate internal controls over cash receipts and disbursements. However, our tests of controls indicated that duties are not adequately separated and prelistings of cash receipts are not prepared.

For further analysis of the abovementioned weaknesses, see the *Findings and Recommendations* section of this report. This report is intended to assist the DIR management in focusing attention on areas of risk and in strengthening internal control and improving operations.

AUDITOR'S REPORT

Mr. John Rea, Acting Director
California Department of Industrial Relations
Office of the Director
455 Golden Gate Avenue, 10th Floor
San Francisco, CA 94102

We reviewed the California Department of Industrial Relations' (DIR) internal control as of October 26, 2005, for conformity with Government Code Section 13400 et seq. Our review included obtaining an understanding of internal control through observations and interviews, identifying risks, testing and evaluating the design and operating effectiveness of the internal control, and performing other procedures we deemed necessary under the circumstances. Moreover, we completed a review over the Electronic Adjudication Management System procurement in a separate draft Management Letter dated November 23, 2005.

The DIR management is responsible for establishing and maintaining adequate internal control. This responsibility, in accordance with Government Code Section 13400 et seq., includes documenting internal control, communicating control requirements to employees, and assuring that the internal control is functioning as prescribed. In fulfilling its responsibility, management is required to assess the expected benefits and costs of its control procedures.

The objectives of internal control are to provide reasonable, but not absolute, assurance that:

- Assets are safeguarded against loss from unauthorized use or disposition.
- Transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of reliable financial statements.
- Financial operations are conducted in accordance with policies and procedures established in the State Administrative Manual.

Because of inherent limitations in internal control, misstatements due to error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

In reviewing the DIR's internal control as of October 26, 2005, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the DIR's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A material weakness is a condition that precludes the DIR's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. We believe the reportable conditions concerning fixed assets and accounts receivable are material weaknesses. These weaknesses and other reportable conditions are described in the *Findings and Recommendations* section of this report.

This report is intended for the information and use of DIR management, and is not intended to be used by anyone other than the designated parties. However, this report is a matter of public record and its distribution is not limited.

Original signed by Diana L. Ducay

Diana L. Ducay, Chief
Office of State Audits and Evaluations
(916) 322-2985

October 26, 2005

We reviewed the accounting and administrative controls at the California Department of Industrial Relations' (DIR) Headquarters and a limited number of field offices, and followed up on prior findings noted in Department of Finance's (Finance) 1997 risk assessment. As indicated in Exhibit I, during our review of prior findings, we noted that a number of the findings remain uncorrected.

We identified several areas as of October 26, 2005, where controls were functioning as intended, including the areas of budgeting and financial reporting. However, we identified areas where controls were not operating as intended, and where corrective action is needed to protect assets from loss. The reportable conditions related to fixed assets and accounts receivable are material weaknesses. If left uncorrected, these weaknesses increase the risk that material errors or irregularities could occur and remain undetected. Corrective action is necessary for the issues noted below.

Fixed Assets

Controls over fixed assets are inadequate to ensure proper safeguarding and reporting of the DIR's fixed assets. We identified significant weaknesses in recording, reconciling, and inventorying property. We believe these weaknesses could have a material effect on DIR's financial statements.

FINDING 1 **Physical Inventory Not Performed (Prior Finding 6)**

Condition: The DIR has not completed a physical inventory. The following conditions were noted:

A. The DIR has not performed a physical inventory count of all its property at least once every three years. Inventory counts were not initiated or scheduled during the prior or current audit.

B. Footnotes in DIR's year-end Statement of General Fixed Assets (Report 19) inaccurately state that physical inventory is performed at least once every three years.

Criteria: State Administrative Manual (SAM) Section 8652 states that departments will make a physical count of all property and reconcile the count with accounting records at least once every three years.

SAM Section 8660 states that the Statement of General Fixed Assets will contain the following:

1. A footnote that inventories of property were conducted in accordance with SAM Section 8652.
2. A footnote that subsidiary fixed assets records are in agreement with the general ledger control accounts.

Recommendations: Schedule physical inventory counts of all property. Due to DIR's many divisions, it may be more efficient for each division to perform a physical inventory count and then submit it to Headquarters for reconciliation to the accounting records.

Accurately footnote any circumstances of non-compliance in the financial statements.

FINDING 2 **Inadequate Capitalization of Fixed Assets**

Condition: Fixed assets are incorrectly capitalized and recorded in the property ledger. We noted the following weaknesses:

A. The DIR does not include sales tax, costs to prepare the item for use, or costs of components needed to put the item to use when capitalizing assets.

B. When recording fixed assets in the property ledger, DIR uses the purchase order amount instead of the final invoice amount.

C. Intangible items, such as computer software, are not capitalized.

Criteria: SAM Sections 8602 and 8615.1 state that tangible or intangible property must be capitalized when the following three requirements are met:

1. Have a normal useful life of at least one year.
2. Have a unit acquisition cost of at least $5,000.
3. Be used to conduct State business.

Furthermore, SAM Section 8614 states that the cost of equipment includes the purchase price plus all costs to acquire, install, and prepare equipment for its intended use.

Recommendation: Ensure that property is accurately capitalized and recorded in the property ledger.

FINDING 3 **Inaccurate Property Ledger (Prior Finding 5)**

Condition: The DIR does not maintain an accurate property ledger. The following conditions were noted during the review:

A. Property is recorded in the property ledger before the item is received. The DIR posts acquisitions to the property ledger when Business

Services receives the purchase order and not when they receive the stock received report.

B. Business Services records the location of property into the property ledger based on the location indicated on the purchase order. However, when the Information Services Unit (ISU) moves property from one location to another, they do not notify Business Services of the move.

C. Assets are entered into the property ledger untimely. As of October 2005, the property ledger did not include all assets purchased in fiscal year 2004-05.

D. DIR does not reconcile the property ledger to the general ledger.

E. The amount reported in the Report 19 is incorrect. The property ledger used to prepare Report 19 does not represent the correct total of fixed assets amounts due to incorrect capitalization of assets and missing records.

Criteria: SAM Section 8650 states that departments will keep track of state property, whether capitalized or not, in an automated property accounting system (if one is used) or on Property Record Cards form, STD. 153-A.

SAM Section 7800 states that the subsidiary records will be reconciled to the general ledger monthly.

SAM Section 8660 states that the Statement of General Fixed Assets will contain the following:

1. A footnote that inventories of property were conducted in accordance with SAM Section 8652;
2. A footnote that subsidiary fixed assets records are in agreement with the general ledger control accounts.

Accounting principles require correct and timely recorded information.

Recommendations: Use stock received reports and final vendor invoices to record property in the property ledger.

Ensure that Business Services is notified of all changes in property location and these changes are subsequently recorded in the property ledger.

Develop procedures to ensure the assets are input timely in the property ledger.

Reconcile the property ledger to the general ledger and investigate variances to ensure that accurate totals are reported in the Report 19.

FINDING 4 **Inadequate Property Dispositions**

Condition: DIR has inadequate property disposition procedures. The following conditions were noted during the review:

A. Property is disposed of before obtaining Department of General Services (DGS) approval. Additionally, when DGS approval is received, dispositions are not being disposed of within 30 days of DGS approval.

B. Not all dispositions are posted to the property ledger. Property was not removed from the property ledger for 2 of 14 property survey reports tested.

C. Property survey reports for lost, stolen, or destroyed items were not reported within a reasonable time, but were completed five to eight months after the incident date.

Criteria: SAM Section 8640 states that before disposing of property, e.g. sale, transfer, trade-in, etc., departments must receive approval from DGS's Property Reutilization. Property listed on the approved STD. 152 will be disposed of without delay, and items held in the suspense file more than 30 days will be reviewed by an agency official to determine why the disposition has not been completed.

SAM Section 8643 states that the department will adjust its property accounting records and retain the property survey reports as documentation.

SAM Section 8643 also states that whenever property is lost, stolen, or destroyed, departments will prepare a property survey report form, STD. 152.

Recommendations: Develop procedures to ensure that DGS approval is received before the property is disposed of and ensure the property is disposed of within 30 days of DGS approval.

Ensure that all dispositions are identified and are accurately posted to the property ledger.

Develop procedures to ensure that lost, stolen, or destroyed property is reported on a property survey report within a reasonable time period.

FINDING 5 **Lack of a Property Survey Board**

Condition: The DIR does not have assigned representatives on the Property Survey Board. Currently, the requester and the requester's supervisor approve dispositions on the Property Survey Report. The lack of a Board increases the risk of fraudulent dispositions.

Criteria: SAM Section 3520.2 states that each agency will have a duly appointed Property Survey Board that is responsible for determining that, when disposing of surplus property, the decision to do so serves the bests interest of the state. To the extent possible, there will be a sufficient number of members on the Board to insure representation by both business management and program responsibilities. At least two Board members must approve all property survey reports and all transfer of location of equipment (STD. 158).

Recommendation: Establish a Property Survey Board and assign specific individuals to the Board.

FINDING 6 Inadequate Tagging Procedures

Condition: Highly desirable property under $500 (faxes, printers, digital cameras, Blackberry devices, etc.) are not tagged or recorded in the property ledger. The DIR has an internal policy of only tagging and recording items $500 and over, unless the items are used by employees who work from home.

Criteria: SAM Sections 8651 and 8650 states that all state property will be tagged after acquisition and recorded in the property ledger. This includes property which does not meet all of the state's capitalization requirements.

Recommendation: Tag and record in the property ledger all items under $500 that are desirable and susceptible to theft.

Receivables

Effective internal controls over receivables are necessary to ensure that all amounts due to DIR are collected and promptly recorded. We believe these weaknesses could have a material effect on DIR's financial statements. We identified the following receivables weaknesses:

FINDING 7 Unrecorded Accounts Receivable (Prior Finding 9)

Condition: DIR is not establishing accounts receivable for amounts due in all areas for which receivables should be established. Specifically, the Division of Labor Standard Enforcement (DLSE) is not recording in DIR's accounting records or financial statements outstanding employer penalty assessments. For calendar years 2003 and 2004, DLSE assessed employer penalties in the amount of $27,854,139 and $29,169,925, respectively, and collected a cumulative total of $13,613,960. However, DLSE did not record potential accounts receivable amounts of $43,410,104 in the accounting records.

Criteria: SAM Section 20050 requires agencies to establish a system of authorization and recordkeeping procedures adequate to provide effective accounting control over assets. This system would include recording all receivables in the accounting records when due, as well as maintaining appropriate subsidiary records.

Recommendation: Record all outstanding assessments in DIR's accounting records.

FINDING 8 Improper Posting of Subsidiary Ledger to General Ledger

Condition: DIR is not properly posting accounts receivable subsidiary ledger amounts to the applicable general ledger. Specifically, the following conditions were noted:

A. Payroll accounts receivable payments are posted to the subsidiary ledger, but not to CALSTARS, resulting in $14,673 discrepancy between subsidiary ledger and CALSTARS for the period July 2005 through September 2005.

B. Posting of payroll accounts receivable to both the subsidiary ledger and CALSTARS may be incomplete. Several individual subsidiary records could not be traced to CALSTARS, and a lump sum amount of $36,739 posted to CALSTARS could not be traced to the subsidiary records.

C. DIR is not reconciling accounts receivable subsidiary records to the general ledger monthly. Specifically, the Oracle, IDMS, and Filemaker accounting subsystem records are not reconciled to CALSTARS monthly.

Criteria: SAM Section 7814 requires that a subsidiary ledger for accounts receivable be maintained for each applicable General Ledger receivable account.

SAM Section 7800 states that a subsidiary records will be reconciled to the general ledger monthly.

Recommendation: Properly post all subsidiary records to the general ledger and reconcile all subsidiary records to the general ledger monthly.

FINDING 9 Collection Efforts Need Improvement (Prior Finding 2)

Condition: DIR's collection program does not ensure that adequate collection efforts are made on accounts receivable. Collection procedures are not promptly and systematically applied in cases of delinquent accounts receivable. Specifically, we noted the following issues:

A. Accounts receivable determined by the DIR to be uncollectible were included as valid accounts receivable in the financial statements, thereby misstating the accounts receivable in the financial statements.

B. There is no evidence of an annual review to identify and remove uncollectible receivables.

C. DIR is not promptly following-up on accounts receivables, and therefore, may not be accurately preparing its annual accounts receivable report. For example, dishonored checks in the amount of $506,411 were outstanding over 120 days. Also, employee receivables over 120 days totaled $253,923. As shown in the schedule below, accounts receivable over 120 days is approximately $35 million. Some of these receivables dated back to 1991.

Schedule of Long Outstanding Accounts Receivable (as of 10/04/05)

Description	Fund	120-365 Days	Over 365 Days	Total
General Fund	0001	$ 3,408,000	$ 23,894,611	$ 27,302,611
Cal-OSHA Targeted	0096	1,218,475	2,194,511	3,412,986
Insurance Fund	0217	0	92,924	92,924
Worker's Comp. Admin.	0223	4,025	131,162	135,187
Elevator Safety Account	0452	2,400	2,351,034	2,353,434
Pressure Vessel Account	0453	66,814	1,450,864	1,517,678
Uninsured Employers	0571	39,192	234,486	273,678
Total		$ 4,738,906	$ 30,349,592	$ 35,088,498

Criteria: SAM Section 8776.6 requires that state agencies develop collection procedures that will assure prompt follow-up on accounts receivable. This SAM Section also provides guidelines that departments will use for the collection of amounts owed to the state from non-employees. Furthermore, if all reasonable collection procedures do not result in payment, departments may request discharge from accountability of uncollectible amounts due from private entities.

Recommendations: Apply collection procedures promptly and systematically to all delinquent accounts receivable. In addition, promptly seek approval from the appropriate control agency to write-off delinquent and uncollectible accounts receivable.

Revolving Fund

DIR's revolving fund consists of the Office Revolving Fund (ORF), Uninsured Employer's Fund (UEF), and the Subsequent Injury Fund (SIF). The ORF is used for the payment of travel and salary advances, and when immediate payment is otherwise necessary. Claims are paid from the UEF when illegally uninsured employers fail to pay workers' compensation benefits awarded to their injured employees by the Workers' Compensation Appeals Board. The SIF is additional payment to injured workers who already have a disability or impairment at time of injury. We identified the following weaknesses in controls over the revolving fund:

FINDING 10 **Salary Advances Controls are not Adequate (Prior Finding 4)**

Condition: Salary advances are not cleared in a timely matter. There is inadequate effort from Personnel to collect salary advances over 120 days. Due to DIR's inadequate collection procedures, as of June 30, 2005, salary advances over 120 days totaled $35,121. Collection letters, emails, and phone calls were not conducted to collect the aged salary advances. We noted the following examples:

A. DIR has five warrants dated September 1, 2003 to December 17, 2004, for two employees with outstanding salary advances. However, no efforts were made to clear the salary advances until information was requested for auditing purposes.

B. Another salary advance was given to an employee on September 3, 2000. The employee transferred to another state agency and the salary advance had not been cleared as of September 21, 2005.

In addition, we noted that multiple salary advances were given to an employee that, in total, exceeded their monthly salary.

Criteria: SAM Section 8776.7 states that departments are responsible for collecting employee overpayments.

SAM Section 8595 states that payroll advances shall be issued for amounts as close as possible to the actual net payments which will be made by the SCO less other amounts due to the agency for advances, maintenance, etc.

Recommendations: Develop procedures to monitor aging salary advances. On a monthly basis, Accounting should send a report to Personnel listing all outstanding salary advances. Personnel should use this report and follow up on all outstanding salary advances.

Develop procedures to track previous salary advances to avoid approving excessive salary advances. Personnel should use the outstanding salary advances report to check for any previous salary advances given to the employees.

FINDING 11 **Inadequate UEF and SIF Procedure Manuals**

Condition: UEF and SIF do not have written procedures for verifying the validity of claims before approving payments. Although there are documented administrative guidelines for UEF and SIF, the guidelines are outdated (May 17, 1993) and do not include detailed procedures for claims processing. We acknowledge that the DIR, Division of Workers Compensation, is currently working on updating its administrative guidelines.

Criteria: SAM Section 20050 states that policy and procedural, or operational manuals either not currently maintained or nonexistent, leaves a control system vulnerable. Entity heads and managers should identify and make the necessary corrections when warned by this danger signal.

Recommendation: With the average case load of 250 cases per Claim Representative, documented procedures of regular duties performed by the Claim Representatives should be developed and included in the administrative guides.

FINDING 12 UEF Inadequately Controlled

Condition: The UEF reimbursement claims are not adequately controlled. Original receipts are not required to be submitted for reimbursement claims. For example, reimbursements are given to an injured worker for payments made to their caregiver. Since the caregiver was ordered by a judge or requested by the injured worker's doctor, reimbursements are usually approved without the injured worker having to submit receipts or invoices to verify that a caregiver exists and is paid.

Criteria: Preferred accounting practices require reimbursements be based on original invoices.

Recommendation: Require original receipts for all reimbursement claims. A verification checklist should be developed to ensure that precautions have been taken to verify the validity of claim.

Cash Disbursements

Effective internal control over the cash disbursement process is necessary to ensure that controls are adequate to safeguard cash, and to prevent and timely detect any errors or irregularities. We identified the following reportable conditions in the internal controls over cash disbursements:

FINDING 13 Inadequate Bank Reconciliation

Condition: Bank reconciliations are not accurately prepared for Account 108, DIR's general checking account. The balance for the ORF does not agree with the G03, Trial Balance by Transaction Code report, for the month of May and June 2005. In April 2005, these differences were listed as reconciling items. However, in May and June 2005, these items were not listed as reconciling items even though they were not cleared. The reconciling items totaling $178,346 were netted against the G03 balance. In September 2005, DIR revised the bank reconciliations from November 2004 to June 2005 to correct the bank reconciliations for Account 108.

In addition, reconciling items are not promptly resolved for Account 114. As of June 30, 2005, there is a total amount of $11,357 in bank deposits in transit dating back to August 1992.

Criteria: SAM Sections 7901 and 7923 state accurate reconciliations are needed to safeguard assets and ensure reliable financial data.

SAM Section 7923 requires the person reconciling the bank statement to trace every reconciling item between the bank and agency's records, and include an explanation on the reconciliation. Also, deposits in transit over 30 days should be resolved.

Recommendations: The person reconciling the bank statement should accurately prepare the bank reconciliation. Moreover, the person who reviews the bank reconciliation should carefully review all items to ensure that accurate information is reported.

Make appropriate adjusting entries to remove the uncleared deposits from accounting records, ensure that all future deposits are accurately recorded, and timely research all reconciling items.

FINDING 14 Uncashed or Unclaimed Checks are not Cleared Timely

Condition: Uncashed or unclaimed ORF and departmental checks over one year old have not been credited back to the ORF or remitted to an escheat revenue account. Outstanding checks are dated as far back as July 25, 2000. For example, the UEF had over $700,000 in checks that were outstanding over one year. The DIR is currently in the process of clearing all uncashed or unclaimed checks and has cleared all of the UEF outstanding checks that were over a year.

Criteria: SAM Section 8042 states that the ORF or general cash checks have a one year period of negotiability and agencies will send stop payment request form, STD 432, to the State Treasurer's Office (STO) for all uncashed checks timed to arrive at least one week prior to the end of the one-year period of negotiability.

Recommendation: Establish procedures to continuously monitor uncashed or unclaimed checks and stop payment at least one week prior to the one-year period of negotiability.

FINDING 15 Inadequate Accountability of Checks

Condition: Check signers do not reconcile checks signed with the daily log maintained by the check preparer.

Criteria: SAM Section 8080 requires strict control over blank checks to prevent unauthorized use. Implicit in this requirement is that the check signers should verify that all used checks were properly issued or voided.

Recommendation: Check signers should reconcile checks signed with the daily log.

Cash Receipts

Effective internal control over cash receipts is necessary to ensure all amounts are properly safeguarded, collected, deposited, and remitted timely to the STO. We identified the following weaknesses in controls over the cash receipts process:

FINDING 16 **Untimely Remittances to the State Treasury**

Condition: Accumulated deposits of $25,000 or more are not remitted to the STO by the first day of the following week. Two out of five of the remittances tested contained deposits of $47,700 and $58,593, respectively. Both were remitted 13 to 28 days after the initial deposit.

Criteria: SAM Section 8091 states that accumulated deposits of $25,000 will be remitted as soon as possible, but no later than the first day of the week following the accumulation.

Recommendation: Remit cash collections to the STO in accordance with SAM.

FINDING 17 **Inadequate Indirect Cost Rate Proposal Approval Procedures**

Condition: Inadequate Indirect Cost Rate Proposals (ICRP) are submitted to the cognizant federal agency prior to receiving approval from the Fiscal Systems and Consulting Unit (FSCU), Department of Finance. The ICRPs for 2004-05 and 2005-06 were submitted concurrently to both FSCU and the cognizant federal agency on January 31, 2005.

Criteria: SAM Section 8756.1 indicates that departments should send their ICRPs to FSCU for review and approval before sending the proposal to the cognizant federal agency.

Recommendation: Obtain FSCU approval on ICRPs prior to submitting them to the cognizant federal agency.

FINDING 18 **Reimbursement Deficiency Claims are Inadequate (Prior Finding 1)**

Condition: Reimbursement deficiency claims are not properly supported or resolved in a timely matter. One of the risk areas identified in our prior risk assessment was that the DIR has long outstanding deposits on the bank reconciliation. It was noted that the general checking account reconciliation as of August 31, 1997, included $79,806 in bank deposits in transit dating back prior to March 1993. This amount had not been credited by the STO due to lack of supporting documentation. It was recommended that the DIR make the appropriate adjusting entries to remove the uncleared deposits from its accounting records.

In February 1999, the DIR incorrectly set up an entry in the general ledger, GL 1316 (Accounts Receivables-Cash Shortage) in the General Fund to remove the uncleared deposits from its accounting records. In June 2005, we informed DIR that the cash shortage should be cleared. DIR resubmitted a claim for reimbursement for the total outstanding deposits in the amount of $79,806 on August 1, 2005, which was originally submitted on December 22, 1994, to offset the General Fund shortage ten years earlier.

Criteria: SAM Section 8072 provides guidelines to clear cash shortages.

Recommendation: Ensure that staff clear outstanding deposits timely to prevent cash shortages.

Purchasing

Effective internal control over purchasing is necessary to ensure that the DIR acquires only those goods and services that are authorized and necessary for effective operations. We noted the following weaknesses in the internal controls over purchasing:

FINDING 19 Split Purchase Orders

Condition: Based on our review of Business Management's electronic purchase order log for 2004-05, computer purchases that should have been combined and submitted to DGS for approval were split into a series of delegated purchase orders. The table below categorizes similar purchase orders and illustrates that each individual purchase order did not exceed the DIR's delegated purchase authority of $500,000. However, if those purchase orders would have been combined, the total purchase amount would have exceeded DIR's delegated purchase authority and would require DGS approval.

PO Number	PO Date	PO Amount	
94-54-17	9/29/04	$	243,823
94-54-20	10/12/04		151,252
94-54-19	10/12/04		306,115
	Total Purchase Amount:	$	701,190
94-54-37	1/5/05	$	283,866
94-54-38	1/5/05		350,295
94-54-40	1/6/05		35,198
94-54-39	1/6/05		247,858
94-54-43	1/7/05		19,985
94-54-45	1/24/05		3,581
	Total Purchase Amount:	$	940,783

Criteria: SAM Section 3572 prohibits circumventing normal procurement methods by splitting purchases into a series of sub-purchases orders or delegated purchase orders.

Recommendation: Ensure that purchases from the same vendor are combined into one purchase order to avoid the appearance of circumventing state procurement procedures.

FINDING 20 **Inadequate Stock Received Reports**

Condition: Of 24 vendor payments reviewed in the accounting files, 4 did not include a Stock Received Report to document that goods were received, and another 4 did not document the date when the goods were received. Without evidence of receipt and approval, vendors may be paid for goods partially or never received.

Criteria: SAM Section 8422.20 states that receiving departments will prepare Stock Received Reports, STD. 106, or use an approved purchase order to record receiving information at the time goods are received. When a copy of the order is used as a stock received report, the person checking the goods will write in the date received, the quantity received, and note any defect in condition. Stock received reports will be filed with the accounting office copies of orders and estimates.

Recommendation: Prepare stock received reports or use an approved purchase order to record all necessary information at the time goods are received, and keep a copy of the completed stock received report in the accounting file.

Contracts

Adequate internal control over contracting ensures that DIR's procurement is effective and complies with state laws and regulations. We noted the following weaknesses in the internal control over contracts:

FINDING 21 **Inadequate Contract Monitoring**

Condition: Contract expenditures are not adequately monitored. DIR does not maintain an expenditure ledger to track invoice payments and contract balances, or to ensure that sufficient funds are available to pay for services rendered. Without an expenditure ledger, there is increased risk of duplicate payments or exceeding the contract amount.

Criteria: State Contracting Manual (SCM) Section 9.09 requires each agency to maintain all invoices, records, and relevant documentation for three years after final payment under the contract. This includes preparing a spreadsheet of expenditures.

Recommendation: Maintain an expenditure ledger for each contract.

FINDING 22 **Splitting of Contracts**

Condition: In 2004-05, there were two occurrences where the DIR had awarded multiple contracts to a single contractor for the same purpose, and the total of the contracts to each vendor exceeded $50,000. In one case, DIR had six contracts with one vendor; however, the combination of four contracts exceeded $50,000 and were not submitted for DGS approval. In the other instance, DIR had four contracts with another vendor of which three contracts combined exceeded $50,000 and were not submitted for DGS approval.

Criteria: SAM Section 1215 states that splitting of contracts to avoid any monetary limitations is prohibited. Furthermore, SCM 4.04 indicates DGS approval is required for contracts over $50,000, unless otherwise exempted from DGS.

Recommendation: Obtain DGS approval for multiple contracts to a single contractor if the total exceeds $50,000.

FINDING 23 Inadequate Liquidation of Encumbrances

Condition: Encumbrances are not properly liquidated. When making a payment for a contract, Accounting is not properly liquidating the encumbrance when payments are not coded with transaction code (TC) 232, Schedule of Expenditure Previously Encumbered.

Criteria: CALSTARS Procedure Manual, Volume 1, Chapter X, page 3 states that a TC 232 should be used to process an automated claim schedule payment for expenditures previously encumbered.

Recommendation: Develop procedures to ensure that all contact payments are charged against the appropriate encumbrance.

Personnel and Payroll

Effective personnel and payroll controls ensure that DIR staff are properly appointed, that payroll information is processed accurately and timely, and that separating employees are properly cleared. We noted the following weaknesses in the DIR's personnel and payroll controls:

FINDING 24 Unauthorized Overtime Requests

Condition: Overtime requests submitted by employees are not pre-approved by the unit supervisor. Three out of four overtime requests tested were signed and dated by the supervisor after the overtime was worked. One of the three overtime requests that was not pre-approved, indicated that the overtime was due to an emergency situation. However, the other two overtime requests did not contain any such information to indicate extenuating circumstances.

Criteria: SAM Section 8540 states that compensation for overtime, either by cash payment or time off, should be based upon prior written approval signed by a designated supervisor. It also states, due to the nature of work carried out by a state agency, management can retroactively approve this compensation.

Recommendation: Overtime requests submitted by employees must be signed and dated by a designated supervisor prior to overtime hours worked or emergency circumstances must be clearly stated.

FINDING 25 **Undeliverable Salary Warrants Not Remitted Timely**

Condition: Undeliverable salary warrants are being held in accounting for over 90 days without correspondence sent to Personnel or being deposited into the Special Deposit Fund. As of September 20, 2005, there were 12 outstanding warrants dated over 90 days, 6 of which were dated 120 days or older.

Criteria: SAM Section 8580.5 states that a written record of all undelivered warrants will be maintained and a copy given to the payroll office. Warrants not delivered within 90 calendar days of receipt must be deposited and remitted to an escheat revenue account in the original fund that provided the resources to the State Payroll Revolving Fund.

Recommendation: Actively track the aging of undeliverable warrants and report those warrants over 90 days old to Personnel and deposit warrants after 90 days into the Special Deposit Fund.

Information Technology

Effective information security controls are necessary to ensure compliance with the state's security and data integrity policies. We observed the following weaknesses:

FINDING 26 **Information System Controls Need Improvement**

Condition: We noted the following weaknesses in the information systems controls:

A. Exiting employees are not promptly removed from the network.

B. Access to accounting functions within DLSE's Oracle database is not restricted to a particular user. Several staff use one password to access accounting functions within the Oracle database.

Criteria: SAM Section 4840 states that state agencies need to ensure the integrity of computerized information resources by protecting them from unauthorized access, modification, destruction, or disclosure, and to ensure the physical security of these resources.

Recommendation: Implement procedures to ensure that exiting employees are promptly removed from the network. Furthermore, control access to applications to only authorized personnel by requiring unique passwords for each user.

FINDING 27 **Inadequate Daily Batch Reconciliation Procedures**

Condition: The DIR does not properly complete daily CALSTARS batch reconciliations. Specifically, the manual daily batch logs are not used to reconcile to the batches processed by CALSTARS. Furthermore, the DIR does not capture the correct system batch records from the CALSTARS CFB710-6-Week To Date Batch Status Report and transfer it to the daily batch reconciliation worksheet. In addition, daily batch reconciliations are not signed by a reviewer.

Criteria: CALSTARS Volume 1, Chapter 18, page 2 states that the batch control log is the primary source of information needed for the daily reconciliation process.

SAM Section 7908 states that all reconciliations will show the preparer's name, reviewer's name, date prepared, and date reviewed.

Recommendation: Ensure batch reconciliations are properly completed and reviewed daily.

Field Offices

Many accounting functions are decentralized within the division or field offices. We conducted a limited review of the DLSE's Sacramento and Los Angeles field offices. Specifically, we reviewed the cash receipt and disbursement procedures. We noted the following weaknesses:

FINDING 28 **Inadequate Separation of Duties**

Condition: Inadequate separation of duties exists over the Los Angeles and Sacramento DLSE cashiering functions. Specifically, we noted the following weaknesses:

A. Both field offices inappropriately route signed disbursement checks through the same person that prepared them for disbursement.

B. The Assistant Labor Commissioner (Commissioner) has incompatible duties related to the Sacramento office. The Commissioner is authorized to sign checks and has access to the blank check stock. In addition, the Commissioner has Oracle database accounting functions.

C. A Senior Deputy III at the Los Angeles office has access to the safe that contains the blank check stock and is authorized to sign checks. Additionally, there is no documentation of who has access to the safe or when the combination was last changed.

Criteria: SAM Section 8080 states that a check will not be routed through the person who prepared or approved the disbursement. Also, no one person shall compare machine-signed checks with authorizations and supporting documents (or signing checks manually after personally comparing them with authorizations and supporting documents) while also having access to blank check stock. In addition, the employee reconciling bank accounts and posting the general ledger or any subsidiary ledger affected by cash transactions shall not have access to the blank check stock.

SAM Section 8024 states that a record will be kept showing: (a) the date the combination last was changed, and (b) names of persons knowing the present combination.

Recommendations:	Route checks for disbursement by a person other than the check preparer. Separate the following functions: recording, authorization, and access to blank check stock. Change the combination to the safe and keep a record of the date the combination was last changed and who has access to the safe.
FINDING 29	**No Prelisting of Cash Receipts**
Condition	The Los Angeles and Sacramento offices do not prepare a prelisting of cash and negotiable instruments not made payable to the state agency.
Criteria	SAM Section 8020.1 states that all incoming mail receipts consisting of cash and negotiable instruments not payable to the state agency, will be prelisted by the person opening the mail to localize accountability of these assets.
Recommendation:	Staff responsible for opening the mail should prepare an ongoing prelisting of all cash or negotiable items that are not made payable to the department.

List of Unresolved Prior Findings

The following table illustrates the prior findings from our Risk Assessment report, dated December 1997, which remained unresolved as of the date of this report. These prior findings have been incorporated into the findings discussed in the body of this report.

Prior Finding Number	Prior Finding Description	Current Finding Number
1	Long Outstanding Deposits on Bank Reconciliation	18
2	Long Outstanding Accounts Receivable	9
4	Uncleared Salary Advances	10
5	Equipment Ledger Not Reconciled	3
6	Undocumented Physical Inventories	1
7	Risks associated with Decentralized Accounting Functions	**
9	DLSE Risk Area - Unrecorded Accounts Receivable for Employer Penalties	7

** Not included in the scope of this review.

Conclusion

Our review of the California Department of Industrial Relations' (DIR) internal controls presents opportunities for DIR management to correct identified weaknesses and improve its operations. We believe internal control would be strengthened and the DIR would operate more effectively if DIR implements our recommendations. The reportable conditions, if left uncorrected, increase the risk that material errors or irregularities could occur and remain undetected. The other material weaknesses, if left uncorrected, could adversely affect the DIR's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The findings in this report are based on fieldwork performed between June 6, 2005 and October 26, 2005. We presented these findings to the related divisions and units at the completion of each cycle, at interim pre-exit meetings, and again during our exit conferences on December 8, 2005. Immaterial, non-reportable findings and observations were also discussed with the DIR staff and management.

DEPARTMENT'S RESPONSE

STATE OF CALIFORNIA Arnold Schwarzenegger, *Governor*

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January 31, 2006

Ms. Diana L. Ducay, Chief
Office of State Audits and Evaluations
Department of Finance
915 "L" Street
Sacramento, CA 95814-3706

Dear Ms. Ducay,

Re: California Department of Industrial Relations – Internal Control Review

Thank you for the opportunity to address the issues raised in the Draft Report on the Department of Industrial Relations (DIR) internal control review. As you know, DIR asked the Department of Finance to perform this review to both comply with the Financial Integrity and Management Accountability Act and to provide DIR management with an independent review of the administrative functions of the Department.

I have organized the response to focus on those issues that DIR finds most critical to its mission. Each Finding, Recommendation, and Response contained in your report is discussed in ATTACHMENT I.

For the most part, the Findings reflect the results of DIR priorities set in an environment with a fewer resources available to it. When faced with the choice of placing staff in headquarters to address administrative issues or placing staff in the field, the field always won.

This letter will focus on two Findings that I believe deserve further discussion because they strike at the heart of DIR's enforcement efforts and because they are Findings that were contained in the more limited review performed by the Department of Finance in December 1997.

Finding Number 7: Unrecorded Accounts Receivable (Prior Finding 9)

The report notes that DIR does not record Accounts Receivables for penalties assessed by the Division of Labor Standards Enforcement (DLSE) and states that there are potential Accounts Receivables of up to $43.4 million. I agree that not recording these receivables has an effect on the annual financial statements, however, this number is not a reliable one. It represents the initial penalties assessed by DLSE field staff without regard to amounts that are appealed – approximately 1/3 of the citations are appealed – or amounts that are ultimately determined not due and collectable.

DLSE by policy requires its deputy labor commissioners to assess penalties to an employer for failing to post proof of workers' compensation insurance. If the employer later provides proof of insurance, the penalty is not due but the records are not adjusted. The workers' compensation penalties represent 47% or $20.3 million of the $43.4 million in penalties receivable in calendar years 2003 and 2004. Yet only between 20 - 28% of these penalties were ultimately determined to be valid penalties and collected. If we properly age just the workers' compensation penalties, one of nine types of penalties recorded, the $43.4 million becomes between $27.1 million and $28.7 million. In some industries, like public works, the penalty can greatly exceed the wages due. DIR focuses on collecting the wages and may waive or reduce the penalties to ensure that the wages are paid. Public Works penalties represent $14.4 million of the $43.4 million. In calendar year 2003 and 2004, between 12 and 17% of these penalties were actually collected.

The good news is that the DLSE case management system will begin testing in May 2006. The case management system will automate the penalty assessment process and enable the departmental Accounting office to post aged receivables to the state accounting system. The information will be posted to the system by DLSE district office staff and the information will be available in real time. In addition, the 2006-07 Governor's Budget proposes to establish a DLSE collection unit to vigorously enforce penalty collection through the filing of judgments, asset search, notification to other regulatory bodies of penalties due to DIR, and staff contact with employers owing penalties. I believe that the availability of reliable data in an automated form will ensure that the financial statements fairly state the receivables.

Finding Number 9: Collection Efforts Need Improvement

This Finding indicates that DIR's collection program does not ensure that adequate collection efforts are made on accounts receivable. The report indicates that approximately $35 million in accounts receivables are over 120 days old.

As a result of this report, DIR has established a task force made up of the Division of Occupational Safety and Health, Accounting, and the Occupational Safety and Health Appeals (OSHA) Board. Previously, the departmental Accounting Office would send out 30 day notice letters to inform employers owing penalties that penalties were due. If an employer appealed the citation and penalty to the OSHA Board, the penalty was not due until the resolution of the appeal. At that time, the OSHA Board was up to 18 months behind on appeals. When the Accounting Office sent out the 30 day notices, many employers sent back letters complaining that the penalties were not due as they were awaiting an appeal. The Accounting office discontinued sending the 30 day notice letters. The OSHA Board now has a 60 day backlog. The DIR intends to begin sending 60 day letters to initiate the collection effort, and has begun the process of writing off any accounts receivable that are older than 2004 where collection efforts have proven fruitless.

It is important to note that the department has been referring delinquent accounts to a collection agency for years. The collection agency is paid as a percentage of accounts collected. However, these efforts have not resulted in notable collections. From calendar years 2002 – 2005, the collection agency has averaged a 5% collection rate with an approximately 4% collection rate for OSHA penalties. To date, the Accounting office has begun processing $2.4 million in write-offs

DEPARTMENT OF INDUSTRIAL RELATIONS
RESPONSE TO 2005 INTERNAL CONTROL REVIEW
FINDINGS AND RECOMMENDATIONS

PROPERTY (FIXED ASSETS)

FINDING 1: Physical Inventory Not Performed (Prior Finding 6)

Recommendation: Schedule physical inventory counts of all property. Due to DIR's many divisions, it may be more efficient for each division to perform a physical inventory count and then submit it to Headquarters for reconciliation to the accounting records. Accurately footnote any circumstances of non-compliance in the financial statements.

DIR concurs. DIR is conducting a physical inventory of all capitalized property with a value of $5,000 and greater to insure that financial statements for 2005-06 are fairly stated. The inventory will be completed in early February 2006. Since the stated goal in SAM 8652 is to reconcile the inventory count with accounting records, and the accounting records expense any item under $5,000 in accordance with State policy, it appears that this inventory count is in compliance with the intent of SAM 8652. The Department will conduct a full inventory later in the year if required.

FINDING 2: Inadequate Capitalization of Fixed Assets

Recommendation: Ensure that property is accurately capitalized and recorded in the property ledger.

DIR concurs. Upon completion of the physical inventory, the property ledger and Accounting records will be adjusted to accurately reflect the capitalized property.

FINDING 3: Inaccurate Property Ledger (Prior Finding 5)

Recommendation: Use stock received reports and final vendor invoices to record property in the property ledger. Ensure that Business Services is notified of all changes in property location and these changes are subsequently recorded in the property ledger. Develop procedures to ensure the assets are input timely in the property ledger. Reconcile the property ledger to the general ledger and investigate variances to ensure that accurate totals are reported in the Report 19.

DIR concurs. Stock Received Reports and final vendor invoices will be used to record property in the property ledger. The Business Management Unit has updated their procedures and will require all divisions to report movement of property in a timely manner. Standard property transfer/disposition forms shall be used. These procedures have been communicated to departmental program staff.

FINDING 4: Inadequate Property Disposition

Recommendation: Develop procedures to ensure that DGS approval is received before the property is disposed of and ensure the property is disposed of within 30 days of DGS approval. Ensure that all dispositions are identified and are accurately posted to the property ledger. Develop procedures to ensure that lost, stolen, or destroyed property is reported on a property survey report within a reasonable time period.

DIR concurs. The Business Management Unit has developed procedures to ensure that departmental and DGS approvals have been obtained prior to the disposition or transfer of property. The Business Management Unit will post the changes to the property ledger. These procedures have been communicated to departmental program staff.

FINDING 5: Lack of a Property Survey Board

Recommendation: Establish a Property Survey Board and assign specific individuals to the Board.

DIR concurs. A Property Survey Board has been appointed and includes staff from Accounting, Business Management, Information Systems Unit, and the programs.

FINDING 6: Inadequate Tagging Procedures

Recommendation: Tag and record in the property ledger all items under $500 that are desirable and susceptible to theft.

DIR is in the process of developing new policies on asset management. Currently, each office is responsible for tracking equipment assigned to unit employees to ensure that minor equipment is returned upon separation. However, tagging of these items would be inefficient and too labor intensive especially in light of the fact that blackberries and cell phones are tracked based on the monthly service and the devices are generally surveyed out once the employee leaves. The low price tag makes it a highly inefficient use of staff time. We believe that this process ensures proper accountability for this state property.

RECEIVABLES

FINDING 7: Unrecorded Accounts Receivable (Prior Finding 9)

Recommendation: Record all outstanding assessments in DIR's accounting records.

The Division of Labor Standards Enforcement's (DLSE) Case Management System (CMS), scheduled for live implementation in August 2006, will allow for better tracking of receivables. DLSE field office personnel can input penalties, appeals, and final assessments. Reports can be generated by case. The DIR Accounting Unit will be given access to the CMS for proper recording of receivables into the Accounting system. In addition, the 2006-07 Governor's Budget proposes to re-establish the DLSE Collection Unit. Once established, the unit will send notices, file judgments and liens, provide notice of A/R penalties due with other regulatory agencies and locate assets.

FINDING 8: Improper Posting of Subsidiary Ledger to General Ledger

Recommendation: Properly post all subsidiary records to the general ledger and reconcile all subsidiary records to the general ledger monthly.

DIR concurs and has started implementing the reconciliation of the accounts receivable subsystem (Oracle, IDMS, and Filemaker) to the general ledger (Calstars) on a monthly basis. In addition, payroll receivables will be closely monitored so that receivables and payments will be properly posted on both the subsidiary ledger and the general ledger (Calstars). Currently, DIR is in the process of reconciling the subsidiary and the general ledger.

FINDING 9: Collection Efforts Need Improvement (Prior Finding 2)

Recommendation: Apply collection procedures promptly and systematically to all delinquent accounts receivable. In addition, promptly seek approval from the appropriate control agency to write-off delinquent and uncollectible accounts receivable.

DIR concurs with the recommendation. The DIR Accounting Office has submitted a request to the State Controller's Office to write-off $2.5M in uncollectible accounts receivables. The Department has received approval from Federal OSHA to write off additional uncollectible accounts receivables through 2004. A committee has been formed with members from DOSH, OSHAB, Accounting, and Administration to develop a collection plan for existing A/Rs as well as future collectibles.

REVOLVING FUND

FINDING 10: Salary Advances Controls are not Adequate (Prior Finding 4)

Recommendation: Develop procedures to monitor aging salary advances. On a monthly basis, Accounting should send a report to Personnel listing all outstanding salary advances. Personnel should use this report and follow up on all outstanding salary advances. Develop procedures to track previous salary advances to avoid approving excess salary advances. Personnel should use the outstanding salary advances report to check for any previous salary advances given to the employees.

DIR concurs. DIR's Accounting Office is currently providing the Personnel Office a monthly report of outstanding salary advances. The Personnel Office will then research and take action to either clear the outstanding salary advances by requesting payment from the Controller's Office or collect overpayments from employees. In addition, current procedures are being updated where the accounting office will verify if an employee has previous outstanding salary advances prior to new salary advances being issued. When this occurs, the Personnel Transactions Supervisor will be contacted for further instructions and approval. The salary advances cited in the audit have been cleared.

FINDING 11: Inadequate UEF and SIF Procedure Manuals

Recommendation: With the average case load of 250 cases per Claim Representative, documented procedures of regular duties performed by the Claim Representatives should be developed and included in the administrative guides.

The Uninsured Employers' Fund (UEF) unit is updating its policy and procedures manual. This manual will include the procedure to be to be followed by Claims Representatives in processing claims.

FINDING 12: UEF Inadequately Controlled

Recommendation: Require original receipts for all reimbursement claims. A verification checklist should be developed to ensure that precautions have been taken to verify the validity of claim.

A very small percentage of UEF claimants receive caregiver reimbursements. These claimants are almost exclusively injured workers who require 24-hour care (quadriplegics), and the caregiver is usually a family member. UEF has developed a procedure in order to verify the care service provided to the claimant. In addition, procedures have been developed to validate services provided by outside professional caregivers

CASH DISBURSEMENTS

FINDING 13: Inadequate Bank Reconciliation

Recommendation: The person reconciling the back statement should accurately prepare the bank reconciliation. Moreover, the person who reviews the bank reconciliation should carefully review all items to ensure that accurate information is reported. Make appropriate adjusting entries to remove the uncleared deposits from accounting records, ensure that all future deposits are accurately recorded, and timely research all reconciling items.

DIR concurs. The reconciling item of $178,346 was a temporary loan made from the Uninsured Employers Fund (UEF) to Subsequent Injuries Fund (SIF) to make immediate SIF claims payments. At end of November 2005, the funds were returned. In addition, procedures have been reinforced to ensure that all future deposits are accurately recorded and timely researched for all the reconciling items.

As to the reported $11,375 bank deposit in transit dated August 1992, DIR Accounting has submitted a claim to the Board of Control to replenish the cash shortage of Account #114 in the amount of $11,375.

FINDING 14: Uncashed or Unclaimed Checks are not Cleared Timely

Recommendation: Establish procedures to continuously monitor uncashed or unclaimed checks and stop payment at least one week prior to the one-year period of negotiability.

To date, all outstanding checks over one year old have been cleared and credited back to ORF or remitted to an escheat revenue account. DIR concurs with the recommendation and will establish procedures to continuously monitor uncashed or unclaimed checks to comply with SAM Section 8042.

FINDING 15: Inadequate Accountability of Checks

Recommendation: Check signers should reconcile checks signed with the daily log.

DIR concurs and procedures are already in place to comply with the auditor's recommendation. A log of checks is maintained and check signers reconcile checks signed with the daily log.

<u>CASH RECEIPTS</u>

FINDING 16: Untimely Remittances to the State Treasury

Recommendation: Remit cash collections to the State Treasurer's Office (STO) in accordance with SAM.

DIR concurs and since the introduction of the electronic cash remittance process, DIR is now in full compliance with SAM Section 8091.

FINDING 17: Inadequate Indirect Cost Rate Proposal (ICRP) Approval Procedures

Recommendation: Obtain FSCU approval on ICRPs prior to submitting them to the cognizant federal agency.

The ICRP for FY 04/05 and 05/06 was submitted simultaneously on January 31, 2005 to FSCU and Department of Labor (DOL). In the future, DIR will obtain FSCU approval prior to submitting ICRPs to DOL.

FINDING 18: Reimbursement Deficiency Claims are Inadequate (Prior Finding 1)

Recommendation: Ensure that staff clear outstanding deposits timely to prevent cash shortages.

DIR concurs. A procedure is in place wherein outstanding deposits over 30 days are followed up with the State Treasurer's Office.

The cited $79,806 bank deposit in transit dating back prior to March 1993 represents a 1997 OSAE audit finding that was not cleared up. DIR has submitted a claim to the Board of Control to clear the shortage.

PURCHASING

FINDING 19: Split Purchase Orders

Recommendation: Ensure that purchases from the same vendor are combined into one purchase order to avoid the appearance of circumventing state procurement procedures.

Generally the DIR prepares separate Purchase Orders by program due to timing and a need to keep the 27 funding sources separate. In the future, the Business Management Unit will combine any Purchase Orders determined to be above DIR's delegated authority. In addition, the state has implemented a new contracting mechanism, the California Strategic Sourcing Initiative, which provides for PCs, servers, and other IT-related products through a single contract. The contract has no dollar limits and does not require bidding.

FINDING 20: Inadequate Stock Received Reports

Recommendation: Prepare stock received reports or use an approved purchase order to record all necessary information at the time goods are received, and keep a copy of the completed stock received report in the accounting file.

DIR concurs. The Accounting Office will ensure that completed stock received reports from the divisions are received prior to processing invoice payments. These procedures have been communicated to departmental program staff.

CONTRACTS

FINDING 21: Inadequate Contract Monitoring

Recommendation: Maintain an expenditure ledger for each contract.

The Business Management Unit has developed procedures for maintaining expenditure logs for each contract. These procedures and formats have been communicated to departmental program staff.

FINDING 22: Splitting of Contracts

Recommendation: Obtain DGS approval for multiple contracts to a single contractor if the total exceeds $50,000.

Similar to Finding 19, DIR's Business Management Unit will combine any Purchase Orders that when combined are determined to be above DIR's delegated authority.

FINDING 23: Inadequate Liquidation of Encumbrances

Recommendation: Develop procedures to ensure that all contact payments are charged against the appropriate encumbrance.

DIR concurs. DIR will follow the appropriate procedure to liquidate the encumbrance with the right transaction code.

<u>PERSONNEL AND PAYROLL</u>

FINDING 24: Unauthorized Overtime Requests

Recommendation: Overtime requests submitted by employees must be signed and dated by a designated supervisor prior to overtime hours worked or emergency circumstances must be clearly stated.

DIR's practice has been for employees to obtain supervisors' verbal approval for overtime requests prior to the overtime being worked. Therefore, the "authorized" signature/date bock is not always signed prior to the overtime worked. The Supervisor approves all overtime at the end of the pay period when the Absence and Additional Time Worked Report (Std. 634) and Authorization for Extra Hours (Std. 682) are submitted.

FINDING 25: Undeliverable Salary Warrants Not Remitted Timely

Recommendation: Actively track the aging of undeliverable warrants and report those warrants over 90 days old to Personnel and deposit warrants after 90 days into the Special Deposit Fund.

DIR concurs. A procedure is already in place wherein undeliverable salary warrants over 30 days are reported to Personnel. In addition, Personnel is also being advised that warrants over 90 days will be deposited into the Special Deposit Fund.

The 12 outstanding warrants dated over 90 days, six of which were dated 120 days or older, cited in Finding 25, were cleared on or before 10/13/05.

<u>INFORMATION TECHNOLOGY</u>

FINDING 26: Information System Controls Need Improvement

Recommendation: Implement procedures to ensure that exiting employees are promptly removed from the network. Furthermore, control access to applications to only authorized personnel by requiring unique passwords for each user.

The DIR employee exit/clearance procedure has been updated to include timely notification to the Information Systems Unit and the Business Management Unit. These procedures have been communicated to departmental program staff and attendance reporting officers.

The control access to applications to only authorized personnel will be corrected in the DLSE case management system scheduled to be phased in by August 2006.

FINDING 27: Inadequate Daily Batch Reconciliation Procedures

Recommendation: Ensure batch reconciliations are properly completed and reviewed daily.

DIR concurs. A procedure has been developed to prepare the daily batch reconciliation with the right Calstars report.

FIELD OFFICES

FINDING 28: Inadequate Separation of Duties

Recommendation: Route checks for disbursement by a person other than the check preparer. Separate the following functions: recording, authorization, and access to blank check stock. Change the combination to the safe and keep a record of the date the combination was last changed and who has access to the safe.

The temporary inadequate separation of duties has been corrected. Additional staff have been hired. Processes have been implemented and the combination of the safe is being changed.

FINDING 29: No Prelisting of Cash Receipts

Recommendation: Staff responsible for opening the mail should prepare an ongoing prelisting of all cash or negotiable items that are not made payable to the department.

DIR has implemented the recommendation and will prepare an ongoing prelisting of all cash or negotiable items that are not made payable to the department.

through the State Controller's Office. The Division of Occupational Safety and Health has received approval through federal OSHA to write off all uncollectible accounts receivable from 2004 and older. In addition, the DOSH is in the process of developing a Request for Proposal to create a new automated system that will more fully meet its current day needs including tracking of penalties and collections. In addition, the Accounting Office has created a contingent accounts receivable for penalties on appeal to ensure that receivables are fairly stated.

The bottom line is that DIR is pursuing automation of its processes to ensure that the maximum number of existing staff may be directed to direct labor law enforcement activities. We are well on our way to compliance with many of the Findings cited in your report and thank you again for the thoroughness of the report and professionalism of your staff.

If you have any questions, please call me at 415/703-5064.

Sincerely,

Original signed by Ann Rose

Ann Rose
Chief, Division of Administration

Attachment

cc: Marisa Duek, LWDA
John Rea, DIR

Evaluation of Department's Response

We have reviewed the Department of Industrial Relations' (DIR) response to our draft report. We acknowledge the DIR's willingness to implement corrective actions for the findings identified in our report, and believe the implementation of the corrective actions identified will strengthen the DIR's internal control and reduce the risk that errors or irregularities affecting the financial statements could occur and remain undetected.

Regarding the responses for Findings 6 (Inadequate Tagging Procedures) and 24 (Unauthorized Overtime Requests), the DIR disagrees with our recommendations. The DIR believes its current procedures are adequate to safeguard property and prevent unauthorized overtime, and assumes responsibility for any potential losses associated with its current practices. If implemented, our recommendations would reduce risks in those areas. As a result, we maintain our recommendation that all items under $500 that are desirable and susceptible to theft be tagged and recorded in the property ledger and that overtime requests be pre-approved by a designated supervisor or clearly state emergency circumstances.